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SUBJECT: NEW ZEALAND ECONOMY FACING RECESSION WHILE BATTLING
INFLATION

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¶1. Summary. The recent slowdown in New Zealand's economy is the result of weaker private consumption growth, owing to higher fuel, food, utilities and housing costs, which are cutting into Kiwis' disposable income. Both business and consumer confidence remains weak amid higher prices and rising unemployment. Fixed investment is subdued as business confidence remains low. Despite this weakening in the economy, the Reserve Bank of New Zealand (RBNZ) is expected to leave interest rates on hold Thursday (July 24), but a reduction of 25 basis points is possible within the next two months as the pressure of a stalling economy outweighs rising inflation concerns. A survey of New Zealand economists indicates that the RBNZ Governor Alan Bollard will wait until the next full monetary policy statement on September 11, by which time he will have a better sense of market trends. Meanwhile, the Finance Minister has limited fiscal stimulus options left to help stave off recession.
End summary.

Monetary Policy

¶2. Monetary policy has been on hold since July 2007, following a significant tightening that left New Zealand's interest rates among the highest in the developed world. However, the RBNZ, which targets an inflation range of 1 to 3%, remains concerned about the outlook for price increases. The RBNZ raised the overnight cash rate (OCR) by 25 basis points on four occasions in 2007, the most recent of which, in late July 2007, saw the rate increased to 8.25%. RBNZ has pointed to the substantial inflationary risks that exist, notably rising oil and food prices, and medium term concerns about the tight labor market and high capacity utilization. The RBNZ forecasts that year-on-year inflation will peak at 4.7% in September 2008 before slowing.

¶3. Local economists believe that the RBNZ will maintain current interest rates when it meets Thursday (July 24). ASB Bank economist Nick Tuffley predicted that a rate cut was unlikely. "We don't think there has been sufficient easing on the non-tradable front to counter concern over high headline inflation," said Tuffley. Westpac chief economist Brendan O'Donovan has a gloomier prediction of inflation rising to 5.5% by the end of September. "I think that there will be the peak so long as oil prices don't shoot even higher," he said. O'Donovan said the RBNZ was in a tricky situation

dealing with "stagflation," i.e., growth falling because higher costs are hitting household budgets while inflation is rising. Longer term, experts believe that monetary policy is likely to ease slightly by the third quarter of 2008 (September).

Business Confidence

¶4. Businesses are the most pessimistic about their future than in 26 years, according to July 2008 Quarterly Survey of Business Opinion (QSBO), which pointed to a recession lasting at least three quarters of the year. A net 18 percent of firms reported a decline in their activity, and the same proportion also expected activity to fall in the next three months, as of the June quarter. Those seasonally adjusted readings were the lowest since June 1998 and December 1982, per the NZ Institute of Economic Research (NZIER). NZIER economists predict two more quarters of economic decline are likely to follow the 0.3 percent fall in Gross Domestic Product (GDP) following the March 2008 quarter.

Inflation and Looming Recession

¶5. Statistics New Zealand reported in July that inflation in New Zealand had jumped by its highest amount in 18 years during the June 2008 quarter, up 1.6% to top 4% for the year. It is the highest inflation has been since June 1995. The consumer price index (CPI) and the food price index were at their highest quarterly levels since June 1990, led by increases in the price of petrol, groceries, utilities and housing costs. The largest contributor to the consumer price index (CPI) rise was petrol, up 12.8% in the June quarter and by 25% over the past year. Food was up 2.2% in the three months to June and by 8.2% over the past year. Electricity was up 3.6% in the June quarter. The rise in grocery prices was higher overall, up by 12% in the past year, led by significant price

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increases in dairy products. Fresh milk rose 22% in price over the year, cheese 62% and butter 86.6%. A loaf of bread was up 15.2%, fruit and vegetables 5.2% and fresh meat and poultry 4.8%.

¶6. Finance Minister Cullen reacted to the news by saying, "the CPI only confirms what New Zealanders already know - that the global commodity boom was putting considerable pressure on household budgets." He went on to say, "it is important to remember that our economic challenges are not of New Zealand's making - the global increase in the prices of petrol and food are outside New Zealand's control."

¶7. The NZ Treasury's June 2008 Report states, "New Zealand may already be in recession experiencing a sharp slowing of growth in early 2008 and pointing to further weakness in the June 2008 quarter." Drought and weaker domestic demand saw the economy contract 0.3 percent in the first quarter, being the first quarterly fall since 2005 and larger than the 0.1 percent fall forecast in the government's May budget update. However, the NZ Treasury said the economy could be expected to recover in the second half of the year under the impact of high dairy prices boosting farmer incomes and cuts to personal tax rates, which come into effect on October 1.

2008 Budget/Fiscal Policy

¶8. Finance Minister Michael Cullen announced a series of stimulus and tax cutting measures in this year's annual budget (see Reftel), which were calculated to regain voters' support. The first tranche of tax cuts are programmed to take effect on October 1, 2008. (Note: Some prognosticators maintain that PM Clark will wait until November 8 to call elections allowing the benefits of the tax relief package to be more acutely felt by voters. End note.) The tax cuts will equate to between NZ\$12 (US\$8.80) and NZ\$28 (US\$21) per week, depending on income level/tax bracket. Corporate taxes were cut from 33% to 30% from April 1st 2008. Economists predict that the rising costs of living will leave the average Kiwi worse off than a year ago. Despite the tax relief scheduled for October, the average New Zealand family will need NZ\$57 more per week than last year to

buy the same amount of goods.

Comment

¶9. In the run-up to the general election, which is expected anytime between September and November 2008, the governing Labour Party is struggling to regain popular support against a contracting economy with high interest rates and rising prices. These economic factors are likely to weigh negatively on the Labour Party's chances of re-election. Meanwhile, the National Party appears to be in no hurry to reveal policy details on issues such as its proposed alternative tax cuts. However, National will come under increasing pressure to outline a comprehensive economic policy laying out National's strategy for dealing with an economic environment that New Zealand voters consider the most decisive factor in the upcoming election.

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